25X1 [redacted]

Articles

IRAN: ECONOMIC PROBLEMS AHEAD (U)

While serving the Ayatollah Khomeini's short-run political purposes, Tehran's current clash with the United States could not have come at a worse time for the Iranian economy. When the US hostages were seized, the economy was basically stagnating after having partially recovered from the downswing inspired by the revolution. After a rupture of several months, Iranian relationships with foreign suppliers and contractors were just beginning to improve. Negotiations to restart some major development projects were progressing well, and a few projects such as the Italian-contracted expansion of Bandar Abbas port had been resumed. [redacted] 25X1

Now, the financial and governmental confusion generated by the US blocking of Iranian assets and by the threats of the Iranians to default on their external debts is having an adverse effect on trade and other external relationships that will be felt for many months to come. In addition, skepticism about the government's ability and willingness to ensure personal security will slow the return of foreign contractors and technicians who are now leaving the country. Overall, spinoffs from the current crisis are undermining Iran's ability to supply itself while making imports more difficult. Hence, another economic dip, as well as spot shortages of critical commodites such as food, seem in the cards over the next several months. [redacted] 25X1

While the economic downturn being brewed by the current crisis is not apt to change the Ayatollah's mind set in the short run, its political impact will be felt in the longer term. Most Iranians are willing to pay some price to ensure the success of the revolution, and for the time being many find the United States a handy scapegoat for most of Iran's problems. Nevertheless, before the current flareup in US-Iranian relations, signs of discontent with the quality of economic management were apparent, especially among some of the staunchest backers of the revolution such as the bazaaris and urban workers. These tensions are likely to grow in the next several months as a result of commodity shortages, accelerated inflation, and persistent

25X1 unemployment. [redacted]

Whether or not the strains generated by a deteriorating economic situation will crystallize into resistance against the Ayatollah's leadership will depend on several factors. Once the crisis with the United States is resolved, the Ayatollah will have to find something else to blame for his policy blunders. He will also have to select his future policy options gingerly, taking care to avoid extremist measures, such as widespread wage and price freezes or forced return to the countryside, which could

[redacted] 25X1

provide a focus for protest. Failure to follow an economic course that holds the promise of a better future for most Iranians would provide opportunities for the left
25X1 and others to exploit. [redacted]

Economic Rollercoaster

Economic activity, which had been progressing at a slow pace during the last year of the Shah's regime, came almost to a standstill during the most tumultuous period of the revolution. Since February, the economy has witnessed the recovery of the important oil sector, the partial recovery of industry, and practically no recovery in construction. Agriculture, which had been lagging before the revolution, was generally
25X1 unaffected by the upheaval. [redacted]

Oil production and exports recovered fairly quickly to about three-fourths of prerevolutionary levels. The Iranian Government established a ceiling on output of around 4 million b/d, but with the continued increases in oil prices in 1979, this level provided crude exports that generated as much revenue as before. Thus money was the least of Tehran's problems in the recovery of its economy. [redacted] 25X1

Nonoil industry which had picked up a little from the lows reached during the revolution then stagnated. At the start of the present crisis, industrial activity was still less than half its prerevolutionary norms. Most Iranians have been unwilling to risk their capital and efforts in the uncertain economic climate. Many upper- and middle-level managers and technicians and most of the successful prerevolutionary entrepreneurial class have fled the country. In September, one Tehran paper estimated that 100,000 middle class citizens had left Iran in the previous six months. The businessmen who remain tend to be more interested in pulling capital out than undertaking new
25X1 investment. [redacted]

Given the uncertainties, government efforts to push money into the system—one reason for the nationalization of the banking system—did not yield much success. In July, the government nationalized the shares of Iranian citizens in the major industrial enterprises it did not already own and began to pump funds directly into the industrial sector. This effort paid off a little, and some foreign joint-venture partners of Iran began to have high hopes for an economic recovery before the Embassy seizure. [redacted] 25X1

Iranian industry, of course, continues to suffer from the loss of trained Iranian managers, technicians, and entrepreneurs and of foreign workers who fled or were forced out of the country. Labor productivity—never high to begin with—dove further as worker councils mushroomed during and after the revolution. Workers demanded a say in the operation of the companies and the right to approve managers. In the last few months, the local revolutionary councils have been forced to place supervisors in industrial plants in order to control worker behavior and to report opponents to the regime. Companies have also been forced to maintain payrolls and to rehire previously fired workers. Despite these measures, at least one-fifth of the labor force (around 2.2 million persons) is estimated to be unemployed; underemployment is staggering, even by Iranian standards. 25X1

The important construction sector remains moribund, although a few development projects have been resumed and some rural reconstruction work undertaken. It was this sector that provided the bulk of jobs for the unskilled rural workers who migrated to the cities during the industrial boom years, and it is this sector that accounts for an estimated 1.0-1.2 million of the unemployed. The general confusion of setting up a new government, the rethinking of development priorities, bureaucratic malaise, unwillingness on the part of managers to make risky decisions, and reluctance on the part of foreign contractors have all contributed to the low level of construction
25X1 activity.

Outward Appearances Deceiving

On the surface, life in Iran goes on much as it did before the revolution. The streets of Tehran are crowded with people and full of traffic; the stores appear generally well stocked with the smaller consumer durables. The food situation appears adequate due to seasonally high supplies of homegrown items and heavy imports of cereals and meats. The unemployment picture is noticeable only in the hundredfold increase in street vendors and the occasional protest—prior to the seizure of the US Embassy—at the Labor Ministry. The people do not seem to be deprived, and in fact most are still receiving paychecks even if they do little productive work. The unemployed survive through vending, occasional day labor, handouts from friends, family, and the mosque, and the small and ill-administered government unemploy-
25X1 ment compensation scheme.

Shortages Developing

Despite appearances, shortages of many commodities are in the works as Iran's ability to supply itself is declining and its ability to import becomes more difficult. With industry only partially in operation, industrial supplies and raw materials are already in short supply. The stock of capital goods must also be in increasingly poor condition. Since the start of the year, aggregate exports of industrial supplies and raw materials by Iran's six major suppliers have fallen about 75 percent compared with 1978. Capital goods exports from these countries have fallen almost as much. To some degree, the drop in purchases reflects financial confusion created by the revolution. Foreign suppliers—even before the recent tangle in Iranian financial affairs caused by the US blocking order—had been demanding confirmed letters of credit (L/C) from Iranian importers before shipping goods. In most instances this means the Iranian buyer must deposit 100 to 115 percent of the face value of the L/C with the issuing bank in advance—a practice the Iranian merchant finds difficult. In other cases, the lack of competent managers meant that supplies of needed parts and materials for government-owned enterprises have simply not been ordered. 25X1

The current financial confusion has added additional uncertainty to the trade and banking situation. The US blocking of Iranian monetary assets has led many foreign exporters to suspend shipments to Iran. Many banks are refusing to accept Iranian L/Cs, fearing lack of payment. In addition, ship operators are refusing to take on Iranian cargo because of (a) problems with loading in the United States; (b) fear that port or labor delays will tie up their ships in Iran and that they will not be paid demurrage cost; (c) fear that the United States may take action, trapping their ships in Iran; and (d) problems with insurance coverage. Even if these factors were reversed now, the leadtime in the production and/or shipping of many of these goods (particularly machinery) could mean several months' delay in receipts. [redacted] 25X1

Before the Embassy seizure, shortages were beginning to be reported on products such as paper goods, including packaging materials; textiles; meat; plastics; vegetable oil; soaps and detergents; medical supplies; auto parts; and motor oil. Since the Embassy takeover, reports of greater shortages have been coming in, and the Iranian authorities have banned the export of all food items from Iran. Certain medical drugs are in severely short supply at hospitals and pharmacies. Eggs and poultry are scarce, and the authorities are scrambling to line up imports of cereals and feedgrains, particularly barley and rice. There are also reports of shortages of premium gasoline in rural areas due to refinery problems. [redacted] 25X1

Outlook

The economic situation—already poor before the Embassy takeover—will almost certainly deteriorate further in the months to come. The financial and governmental confusion, as well as the lack of security generated by the current crisis, will continue to have effects for some time: (a) foreign suppliers will become more reluctant to sell to Iran; (b) foreign contractors and workers will be more reluctant to work in Iran; (c) foreign banks will push back even further any ideas of lending Iran money; and (d) more middle class Iranians will seek to leave the country. Once the hostage situation is resolved, revolutionary fervor will recede and the workers and unemployed will be reminded of their previous demands for an improvement in their lot in life. Shortages of basic commodities are likely to grow instead of decline. Civil strife may also cut into planting and harvesting next year, exacerbating the food situation. Oil will still be Iran's one hope, but here too production may fall due to labor and/or equipment problems. All in all the outlook is not good, and the Ayatollah's short-sighted policies of the present are sowing problems for him in the future. [redacted] 25X1

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MAJOR DEVELOPED COUNTRIES: US-IRANIAN FINANCIAL DISPUTE SPREADS [redacted] 25X1

West European banks, industrial firms, and governments are being drawn reluctantly into the US-Iranian financial dispute. Iran apparently is trying to service

only debts to non-US lenders, but this is difficult in syndicated loans. While American banks are pressuring their foreign syndicate partners to declare Iran in default, foreign bankers want to allow Iran more time to meet interest payment obligations. So far as we know, the Japanese—both bankers and government officials—have been the most
25X1 accommodating to Iran.

In a development that has just become public, French courts have frozen Iran's $1 billion stake in the West European uranium enrichment consortium, EURODIF. The freeze, which was triggered by Iran's failure to meet its financial obligations to EURODIF, actually predates the US order blocking Iranian assets, but its surfacing at this time could prove awkward for Paris. In London, British courts, in response to suits and countersuits involving Iranian deposits, have frozen at least temporarily all official Iranian assets in the United Kingdom. 25X1

Technical Defaults Spread

Iran has fallen into arrears on several loans, at least initally because the US block of Iranian assets made it more difficult to service loans on time. The first default was declared on 21 November, when a US bank announced that Iran had failed to pay interest on a $500 million loan. Cross-default clauses—whereby Iran's failure to service one loan can produce defaults on other loans—add considerably to the confusion. Iran has further complicated the issue by refusing to define exactly which
25X1 debts it intends to honor.

West European and Japanese banks thus far have refused to join in declaring Iran in default on syndicated loans. Nevertheless, some foreign-owned banks with offices in New York have filed precautionary suits to attach Iranian assets held in the United States. In one suit, the Union de Banques Arabes et Francaises (UBAF), a Franco-Arab bank based in Paris, is seeking a judgment of $2 million plus interest and costs to reclaim its share of a $270 million loan to Iran. Thirty percent of UBAF stock is held by Credit Lyonnais, which in turn is 100-percent owned by the French Government. In another suit, European American Banking Corporation, owned by a consortium of European banks, is seeking a judgment against $8 million in outstanding Iranian
25X1 debt.

In London, three British banks are faced with at least technical defaults on loans made to Iranian Government institutions. Interest payments on these loans are overdue, but the British banks have granted Iran more time to pay. 25X1

Foreign Reaction to Freeze and Defaults

Pressures from US banks to declare Iran in default, as well as warnings that US banks do not intend to share Iranian assets seized in offset actions, have produced some hostile reactions from foreign bank partners. Part of the hostility stems from the fact that most syndicate agreements provide that any proceeds following a default must be shared. West European bankers have described the US default declarations as premature, confrontational, and politically motivated. In addition to putting all West European lenders in the difficult position of having to decide whether or not to act in response to cross-default clauses, US actions have raised fears among Swiss and West German bankers that their currencies will be used increasingly as reserve assets and settlement currencies. European bankers also have pointed out that the blocking order in US banks abroad could set a precedent for future US attempts to control Eurocurrency markets. 25X1

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